

**Pre-Paid Legal's Promise:
An Insurance Firm or a Matching Network?**

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“Similar to the principles underlying health insurance, pre-paid legal insurance plans are a mechanism to spread risks across group. They are based on the premise that, with near certainty, some individuals will encounter major legal expenses in the future.”¹

Introduction:

Pre-paid legal programs have long promised a cure-all for Americans’ legal woes: make a low monthly payment and never again worry about legal bills. Many programs have been explicit in pledging to customers both lower prices on legal services and risk mitigation.² And most analysis of these plans has accepted that they serve an insurance function.³ On closer inspection, however, we find that most of these firms operate businesses very unlike insurance. Instead, the plans tend to limit coverage to discrete services and better resemble a provider of a matching network, leveraging scale advantages and network effects to create value for customers. In this paper, we will first explain the insurance model and use it as background for highlighting the stark differences between a major pre-paid legal services provider and typical insurance firms. Second, we will introduce the concept of a networked business and examine how pre-paid legal services providers offer certain affordable, quality legal services to customers through a two-sided matching network. While we believe that these firms may play a valuable role in the legal services landscape, it is important to dispel the popular myth that they serve an insurance function: any guarantee of significant risk mitigation appears no more than an empty promise.

¹ Justin Osofsky’s “The Pre-Paid Paradox: Analyzing the Controversy over Pre-Paid Legal Services, Inc.” (May 2005) (unpublished manuscript, on file with author), p. 5.

² <http://www.prepaidlegal.com/> ; <http://www.aragggroup.com/>

³ See Osofsky; Stephen F. Herbes, *Prometheus or the Trojan Horse?: A Look at the Prepaid Legal Services Industry in the United States*, Delivery of Legal Services course packet at 908. Employee Benefit News encourages this view by recommending legal plans be evaluated based on their rating from A.M. Best, an independent organization that rates insurance companies by financial strength. *Ten Tips for Evaluating Group Legal Plans*, Employee Benefit News (Dec. 1998).

The Nature of Insurance:

Insurance companies are structured to allow their customers to protect against certain pre-specified risks. Customers buy contracts from insurance companies which are assets to the customers but liabilities to the insurance company.⁴ The company then typically uses the money represented by these liabilities to invest in financial assets. Thus the insurance company generates profits in two ways: by selling contracts for more than the economic value of the expected payouts and by receiving a return on its investments.

To understand insurance, it is essential to understand why insurance companies are able to charge more for the contract than the contract's economic value. Indeed, insurance companies are heavily regulated on the asset side of their balance sheet. Their investment portfolio is subject to numerous restrictions that put it at a significant disadvantage relative to other investment pools. So companies can only be profitable if their payouts to customers are less than the economic value of the stream of premiums they receive – effectively, borrowing from customers⁵ in an inefficient market at beneficial terms.⁶

Customers are willing to pay more for insurance than the expected value of the loss because the insurance company provides an efficient way to pool risk and customers are risk averse. The nature of these risks is such that pooling makes payouts more

⁴ Zvi Bodie and Robert Merton, *FINANCE* Prentice-Hall, Inc. (2000), p. 293.

⁵ Unlike asset based businesses that borrow from financial markets to invest in bringing products to customers, insurance companies borrow from their customers in order to invest in financial assets.

⁶ J. Hancock, P. Huber & P. Koch, *Swiss Re: The Economics of Insurance, How Insurers Create Value for Shareholders (2nd Addition)* SWISS REINSURANCE COMPANY (2001), p. 8.

predictable allowing an insurance company to accurately forecast payouts across their customer population and price contracts profitably.⁷

Pooling of risk is simply a market solution to the old saying, “don’t put all your eggs in one basket.” As individuals, we are exposed to numerous risks that we cannot bear on our own. These risks include risks to property, family wages (due to injury or death) and high expenditures (due to health or legal bills). While a family may suffer terrible financial loss due to the death of a primary wage earner, an insurance company can afford to replace those wages. After all, the company receives payments from customers who do not all die at once. In this way, insurance is doing something more than just borrowing money from customers to be paid back later. Instead, it is providing diversification for the customer that he could not create on his own.

Diversification is one of the few free lunches in economics.⁸ If two assets are less than perfectly correlated, you can achieve the same amount of return with lower risk by owning both rather than only one.⁹ Thus an insurance company which has the financial heft to hold a diversified portfolio of risks bears less risk but has the same expected return as its customers. It can then offer a small discount to customers and keep much of the value of diversification for itself.

A simple example will help illustrate the insurance function. A customer has a home that would cost one million dollars to rebuild. Its chance of being destroyed by a

⁷ Ibid.

⁸ Economists likely assume away this free lunch by assuming everyone is optimally diversified and those that are not bear a cost.

⁹ This is an analytical fact. The return from a portfolio of assets (A and B) is the weighted average return of each asset in the portfolio. If w is the weight of assets held in A and $(1-w)$ is the weight in asset B then $\text{Return}(A+B) = w \cdot R(A) + (1-w) \cdot R(B)$. The variance of returns (the primary method for measuring risk), however, is the $w \cdot \text{Var}(A) + (1-w) \cdot \text{Var}(B) + 2(w)(1-w) \cdot \text{covariance}(A,B)$. (Bodie, p. 329). If covariance of A and B is less than 1, then the variance and hence risk has been reduced. Leverage enables the return to be adjusted to the *ex ante* level while variance remains below the *ex ante* level.

natural disaster is one in a thousand. How much should she pay to protect her house? The expected value of the loss is only \$1000.¹⁰ But she is not risk neutral; she is risk averse. She is hurt by the loss of her house much more than she benefits from the increased savings. Indeed, she likely cannot bear a one million dollar burden if disaster strikes. She will almost certainly pay much more than \$1000 for someone to pay her \$1,000,000 if the earthquake does come. But why would anyone be willing to take the other side? Are some market participants not risk averse but risk seeking? No. Insurance companies are willing to take the other side because they play the game across 1000 customers and therefore do not fear the one large loss. This ability to withstand loss relies on the assumption that the probability of an event occurring isn't just low but that it is also uncorrelated with other events. If the insurance company plays this game and an unlikely event causes all 1000 customers to lose their homes, then it is exposed to exactly the same risk as the customers themselves. Thus the key drivers of insurance pricing are the level of risk exposure, the breadth of the customer base, and the correlation of risks.¹¹

These drivers of profitability expose insurance to two dangerous market distortions. The first is *adverse selection*. Adverse selection occurs when products of different qualities are sold at a single price because the buyers or sellers do not have enough information to uncover the true value of the product at the time of sale.¹² It occurs in the insurance context when an insurance company cannot accurately assess the true risk profile of a customer. This can cause dramatic market distortions. If it were to

¹⁰ The amount of loss times the probability of loss: $\$1,000,000 * (1/1000)$

¹¹ These drivers help explain one reason why union and employer-based legal plans exclude coverage against employers. The risk of such litigation for a pool of employees is highly correlated since any layoff might result in hundreds of similar suits.

¹² Robert S. Pindyck and Daniel L. Rubinfeld, MICROECONOMICS (5TH ADDITION) Prentice- Hall, Inc. (2001), p. 598.

insure someone blindly for medical expenses an insurance company would have to charge the same price to smokers as non-smokers. To cover the risk that its population contains some smokers, it is likely to have to charge a higher price than a healthy person would be willing to pay to receive the treatment. But the consumer knows whether he is a smoker or not and therefore will not purchase the insurance at that price. Inadvertently, due to this adverse selection phenomenon, the insurance company could end up having only smokers in its customer population and it will have contracted with them at an unprofitable level of coverage. Two solutions present themselves: eliminate coverage for this treatment to all customers or price discriminate between customers who pose the risk and those who do not. Since holes for health insurance render it worthless, insurance companies work hard to select customers based on their risk profile and tailor products and pricing to a customer's specific needs. As we will discuss later, legal plans have few eligibility requirements and address adverse selection by simply limiting benefits.

The second distortion common in insurance is a phenomenon called *moral hazard*. “When one party is fully insured and cannot be accurately monitored by an insurance company with limited information, the insured party may take an action that increases the likelihood that an accident or injury will occur.”¹³ Someone who has car insurance is more likely to drive aggressively than someone who does not because the risk of an accident is less costly. In the legal context, just as with cars, those with insurance may take advantage of it and consume more services. Instead of pricing differently based on expected behavior, as car insurance companies do, legal plans simply count on the limited services they offer to discourage over-consumption.

¹³ Ibid, p. 606.

Thus an insurance company can be expected to structure its pricing contracts based on level of risk exposure, the broadness of the customer base, and the correlation of risks. In addition, it will attempt to collect information about its customers prior to signing and look for ways to monitor behavior after the purchase. Pre-paid legal plans do not appear to make such considerations. An examination of the financial statements of each business will help underscore the differences in the models.

Comparing Insurance and Pre-Paid Legal Plans:

Direct-to-consumer pre-paid legal service providers do not appear to exhibit the essential features of insurance.¹⁴ The leader of this direct-to-consumer segment is Pre-Paid Legal Services Inc.¹⁵ The company's recruitment effort uses current members to recruit new members.¹⁶ Though this may be an efficient way to achieve scale, it suggests little attempt to create a diverse customer base. The covered services tend to be transactional (document review, phone calls, etc.), low risk and highly correlated. Indeed, not only does everyone need a will or help with a basic lease, but those who join are likely more aware of this need than the average population, suggesting the company ignores adverse selection concerns. In addition, when expensive litigation arises, the company, while often offering guaranteed and discounted rates, exposes the customer to

¹⁴ Union plans and employer-provided plans capture the vast majority of members but most plans, e.g., UAW, operate with full-time salaried attorneys and highly correlated risks. Although they offer somewhat broader coverage which may better resemble insurance, their limited capacity (the salaried attorneys can only take on so many matters) and failure to manage adverse selection or moral hazard (no price discrimination among customers) do offer distinctions with traditional health insurance. In addition, the plans do not appear to offer coverage for work-related litigation and allow lawyers to reject certain complicated tort matters.

¹⁵ Our analysis also focuses on direct-to-consumer because these companies, e.g., Pre-Paid Legal Services, Inc., often make the boldest claims to insurance-type benefits. We use Pre-Paid Legal to illustrate this segment because, as a public company, it offers the most detailed financial information.

¹⁶ See Osofsky, "The Pre-Paid Paradox."

the risk of high variable costs associated with complicated legal work. The firm may not supplement any of the lawyer's costs in expensive legal matters, leaving the risk entirely with the individual and the lawyer. In other words, the company appears to have structured its coverage to avoid any insurance-type risk, although Pre-Paid Board members still boast: "Does our product cover everything? Yes."¹⁷

An analysis of Pre-Paid Legal Services Inc.'s financial filings further highlight the distinctions between the company and a conventional insurance firm. This financial perspective may offer a clearer picture of the firm than a description of its services, which don't lend themselves to easy cost-benefit analysis. First Pre-Paid's income statement doesn't resemble other insurance companies:¹⁸

	Prepaid Legal		Aflac		Aetna		Pacificare Health	
	12/31/2004		12/31/2004		12/31/2004		12/31/2004	
Revenue	\$ 385,937	% of revenue	\$ 13,281,000	% of revenue	\$ 19,904,000	% of revenue	\$ 13,950,000	% of revenue
Cost of revenue	\$ 151,605	39.3%	\$ 8,482,000	63.9%	\$ 13,829,200	69%	\$ 10,173,779	73%
SG&A	\$ 172,077	44.6%	\$ 2,992,000	22.5%	\$ 4,028,800	20%	\$ 1,561,247	11%
Net Income	\$ 40,777		\$ 1,299,000		\$ 2,245,000		\$ 368,350	

An insurance company's cost of revenue represents the cost of paying off insurance claims. Pre-Paid's cost of revenue as a percent of total revenue is over 50% lower than the average of the other insurance companies. In addition, its cost of selling is over 100% higher as a percent of revenue than other insurance companies. This cost structure indicates a focus on marketing itself (through its multi-level marketing structure)¹⁹ than on providing benefits to subscribers.²⁰ Indeed it appears that from a purely variable cost

¹⁷ Christopher Palmeri, "On the Defense at Pre-Paid Legal Services", Business Week (Apr. 25, 2002) at http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020425_0617.htm (quoting Pre-Paid Legal Services, Inc. Board Member David Savula).

¹⁸ Taken from public filings and finance.yahoo.com

¹⁹ See Osofsky "The Pre-Paid Paradox."

²⁰ Herbes paper claims that plans provide "an average of \$1.50-\$1.75 in legal service value for every \$1.00 of premium received." Although we are unable to verify this number without further information, we believe that it misstates "value." The retail price of services might be \$1.50 but the actual value received by customers is likely significantly lower since retail prices assume no bulk purchasing, higher marketing

standpoint, Pre-Paid's customers are paying dramatically more than the economic value of the services for which they receive, and far more than a typical insured party would.²¹

Three possible reasons may explain this lower payout ratio. First, the specific risks facing Pre-Paid's customers may be so great that they are willing to pay huge premiums above expected value. Second, as we discuss later, Pre-Paid may operate as a networked business where each customer values membership more as additional services/attorneys join the network and Pre-Paid therefore spends heavily on sales in order to feed cross-side network effects. Finally, the firm may have created a strategy that it grows as a result of a pyramid marketing scheme that does not actually increase value for customers.²² We expect that the truth lies somewhere between the second and third explanations.

The first explanation, high levels of risk aversion, is easily dismissed when the actual benefits provided are compared against those offered by true insurance firms. It is inconceivable that customers will pay higher premiums and therefore allow higher margins in the legal insurance market than in the catastrophic health market (covered by firms in the sample above). This is especially true when one considers the limited benefits of typical programs (see **Exhibit A**). There is no program that offers full coverage for complicated legal matters that can be so costly. In addition, a cursory look at Pre-Paid's balance sheet reveals it is not prepared to pay off in the event significant risks materialize.

costs and full utilization. Indeed, prepaid plans could not operate long-term if they were providing \$1.50 in real value for every \$1.00 received.

²¹ The gross margin (revenue – cost of revenue) is very high meaning that the direct costs of providing the service is very low.

²² Osofsky's paper essentially claims that Pre-Paid's multi-level marketing model is a pyramid that "has enabled the company to grow rapidly ... [but] now poses substantial threats to [its] long-term sustainability." (p. 22).

	Prepaid Legal		Aflac		Aetna		PacifiCare Health	
	12/31/2004		12/31/2004		12/31/2004		12/31/2004	
	\$1,000s	% of Total Assets	\$1,000s	% of Total Assets	\$1,000s	% of Total Assets	\$1,000s	% of Total Assets
Current assets								
Cash and equivalents	\$ 25,972	17.8%	\$ 3,813,000	6.4%	\$ 193,300	1.6%	\$ 824,104	15.8%
Short term investments	\$ 804	0.6%	\$ -	0.0%	\$ 559,400	4.7%	\$ 1,936,765	37.1%
net receivables	\$ 11,031	7.6%	\$ 417,000	0.7%	\$ 244,400	2.1%	\$ 466,064	8.9%
Inventory	\$ 1,623	1.1%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Other current assets	\$ 15,420	10.6%	\$ -	0.0%	\$ 42,700	0.4%	\$ 54,746	1.0%
Total current assets	\$ 54,850	37.6%	\$ 4,230,000	7.1%	\$ 1,039,800	8.8%	\$ 3,281,679	62.8%
Long term investments	\$ 29,836	20.4%	\$ 48,637,000	82.0%	\$ 10,332,300	87.5%	\$ 140,298	2.7%
PPE	\$ 51,232	35.1%	\$ 515,000	0.9%	\$ -	0.0%	\$ 226,594	4.3%
Goodwill	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ 1,278,677	24.5%
Intangible assets	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ 227,122	4.3%
Accumulated amortization	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Other assets	\$ 10,146	6.9%	\$ 349,000	0.6%	\$ 178,500	1.5%	\$ 72,547	1.4%
Deferred long term asset charges	\$ -	0.0%	\$ 5,595,000	9.4%	\$ 261,500	2.2%	\$ -	0.0%
Total Assets	\$ 146,064	100.0%	\$ 59,326,000	100.0%	\$ 11,812,100	100.0%	\$ 5,226,917	100.0%
		% of total Liabilities and Shareholder Equity		% of total Liabilities and Shareholder Equity		% of total Liabilities and Shareholder Equity		% of total Liabilities and Shareholder Equity
Current liabilities								
Accounts payable	\$ 23,247	15.9%	\$ 5,470,000	9.2%	\$ 438,000	3.7%	\$ 1,706,736	32.7%
short/curret debt	\$ 18,374	12.6%	\$ -	0.0%	\$ -	0.0%	\$ 37,534	0.7%
other current liabilities	\$ 34,925	23.9%	\$ -	0.0%	\$ -	0.0%	\$ 89,496	1.7%
Total current liabilities	\$ 76,546	52.4%	\$ 5,470,000	9.2%	\$ 438,000	3.7%	\$ 1,833,766	35.1%
Long term debt	\$ 28,668	19.6%	\$ 1,429,000	2.4%	\$ 1,609,700	13.6%	\$ 1,051,520	20.1%
Other liabilities	\$ 2,794	1.9%	\$ 44,854,000	75.6%	\$ 683,000	5.8%	\$ 38,460	0.7%
Deferred long term liability	\$ 6,609	4.5%	\$ -	0.0%	\$ -	0.0%	\$ 114,733	2.2%
Minority interest	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Negative goodwill	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Total Liabilities	\$ 114,617	78.5%	\$ 51,753,000	87.2%	\$ 2,730,700	23.1%	\$ 3,038,479	58.1%
Stockholder Equity								
Misc options	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Redeemable Preferred Stock	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Preferred Stock	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Common stock	\$ 205	0.1%	\$ 65,000	0.1%	\$ 3,076,500	26.0%	\$ 861	0.0%
Retained Earnings	\$ 129,290	88.5%	\$ 9,409,000	15.9%	\$ 6,546,400	55.4%	\$ 647,168	12.4%
Treasury stock	\$ (99,028)	-67.8%	\$ (2,561,000)	-4.3%	\$ -	0.0%	\$ -	0.0%
Capital Surplus	\$ -	0.0%	\$ 468,000	0.8%	\$ -	0.0%	\$ 1,569,118	30.0%
Other stockholder's equity	\$ 980	0.7%	\$ 192,000	0.3%	\$ (541,500)	-4.6%	\$ (28,709)	-0.5%
Total Stockholder's equity	\$ 31,447	21.5%	\$ 7,573,000	12.8%	\$ 9,081,400	76.9%	\$ 2,188,438	41.9%
Liabilities + Shareholders Equity	\$ 146,064	100.0%	\$ 59,326,000	100.0%	\$ 11,812,100	100.0%	\$ 5,226,917	100.0%

On the asset side, insurance companies are heavily weighted to investments and cash.²³ As described earlier, insurance companies collect cash from premiums. They keep some of it on hand to pay claims and invest the rest to earn investment income.²⁴ Pre-Paid Legal has only 40% of its assets in investments and cash. Indeed it has over 35% of its assets in property, plants and equipment (PP&E) while the company with the next highest proportion in PP&E maintains only 4%.

²³ PacifiCare's asset numbers are a bit distorted due to large amounts of goodwill likely resulting from an earlier acquisition. Removing this goodwill from the balance sheet, cash and investments represent 73% of the company's assets.

²⁴ J. Hancock et al., *The Economics of Insurance*, p. 8.

Looking at liabilities, Pre-Paid has dramatically higher short term liabilities than the insurance companies. Indeed, only Pacificare possesses higher short term liabilities and it has equivalently high short term investments and cash which suggest that it insures frequent risks.²⁵ Of course, few risks can be more frequent than legal advice – certainly there’s no seasonality as with hurricanes. But Pre-Paid’s current assets are almost half of Pacificare’s. The reason is that the firm doesn’t insure frequent risks, it simply has significant payables associated with its commissions to salespeople. The marketing model rather than the risks of its customers is driving the structure of Pre-Paid Legal’s balance sheet.

It is difficult to undertake this comparison of all pre-paid legal plans without access to their financial statements. One can, however, speculate that the structure of their programs prevent them from operating as true insurers. As mentioned earlier (*see* FN 14), union, employer or even non-employer group plans, e.g., AARP, work from a fixed population selected for characteristics other than their need for legal insurance.²⁶ On the one hand, this feature ignores adverse selection since there is no price discrimination. On the other hand, if the pool is sufficiently large, adverse selection may be mitigated since no one is selected based on need for insurance so broad coverage may be effectively provided. Moral hazard is simply managed by limiting capacity. The UAW, for example, has a staff of lawyers who can only take on so many matters so capacity constraints achieve what higher prices for overuse accomplish in car insurance.²⁷

²⁵ By “frequent,” we mean both more often to a particular customer and more likely among customers.

²⁶ For further analysis on AARP’s plan, *see* W. Moore & M. Kolasa, *Legal Services Delivery Model: AARP’s Legal Services Network: Expanding Legal Services to the Middle Class* 32 WAKE FOREST L. REV. 503 (Summer 1997).

²⁷ For further analysis on UAW’s plan, *see* Deborah B., *Early Experience of the UAW Legal Services Plan: A Report on Operations from 1978 through 1981*, (March 1982) (unpublished manuscript, on file with author).

The key takeaway, however, is that these plans still are relatively limited to basic services and therefore do not “insure” against catastrophic legal expenses.

The Nature of Networked Businesses:

If Pre-Paid Legal Services is not a real insurance business, the question remains how what type of business is it and how has it generated such high rates of membership growth? One possibility is that Pre-Paid is a networked business. Such businesses represent an increasing portion of the global economy. Networked businesses are best recognized in communications, consumer electronics and technology sectors. But they can also be found in financial services, transportation and even online dating services. In general, there are three types of networks that one sees operating in business: connectivity, complement and matching.²⁸ Connectivity networks facilitate point-to-point transfers of information or physical goods, e.g., telephones or FedEx. Complement networks link the production of a platform and complement products where growth in the production of the platform spurs growth in product development, e.g., PlayStation and PlayStation video games. Finally, matching networks help users screen pools of potential transaction partners, lowering search costs by creating an identifiable marketplace.

Direct-to-consumer prepaid legal plans share certain similarities with two-sided matching networks. A platform provider, e.g., Pre-Paid Legal Services, sits between two sets of users: attorneys and plan members. The provider seeks to optimize network volume by pricing and regulating each side in a way that increases demand for participation in the network. The following analysis details the essential characteristics

²⁸ This taxonomy and much of this description of network effects can be found in Thomas R. Eisenmann, *Network Effects and Platforms, Part I: Core Concepts* HBS CASE #N9-806-055 (September 15, 2005).

of a two-sided matching network and highlights how prepaid legal plans pool members to take advantage of both network effects and scale benefits.

Demand Side Effect:

A networked business provides a platform and manages interaction among members. Such a business is distinctive because it benefits from strong positive externalities which drive demand from customers. Most people tend to be familiar with negative externalities: where X's actions harm Y without compensating Y for her harm. Pollution offers the classic example. A positive externality occurs when Y receives a benefit from X without paying for it. A "network effect" is the positive externality in which one user's value of participating in a network increases when additional users join the network. The fax machine serves as the paradigmatic case for such a phenomenon in a connectivity-based network. A fax was useless to its first purchaser until a second purchaser enabled the two to communicate. As more users joined the network, the utility of the fax for the first user increased because the machine could transmit to more people and thus she valued her machine more dearly.²⁹ This initial user paid nothing to additional users even though their membership created extra value for her fax. The benefit to her from their participation came at no cost to her: a positive externality

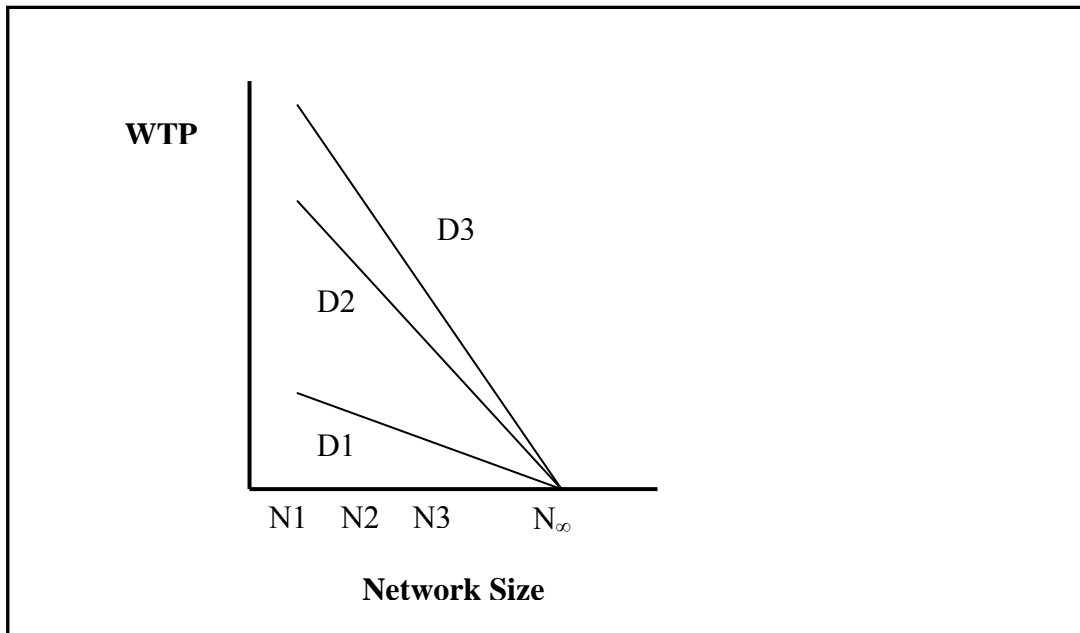
The following graph illustrates the power of a network effect.³⁰ Since value increases for all users of the network as more join, willingness-to-pay (WTP) for the

²⁹ Networks exist in the legal profession as well. Louis Cohen, a co-author's father, has often said: "When a town has one lawyer, he starves to death. When a second lawyer moves to town, they both get rich"

³⁰ Eisenmann, p. 9.

service increases for prospective users and existing customers as membership expands.³¹ This is a demand-side effect since WTP influences the revenue side of the profit equation. As the network grows from N_1 to N_2 , the aggregate demand curve shifts outward from D_1 to D_2 .

Figure 1: Network Effects



Transaction Variety:

Variety of transaction partners contributes to strong network effects. For example, the 100th purchaser of a fax creates incremental value for the first user only to the extent that she might someday seek to communicate with the 100th user. Similarly, the quintessential two-sided matching network, a yellow pages business, enhances user value by increasing vendor advertising because users are uncertain which vendors they will

³¹ The increase to willingness-to-pay becomes incremental after a critical number of users join. However, in theory, an additional purchaser of a fax machine increases the value of all existing machines since it adds another party with whom to communicate.

need to contact. By placing all relevant information into one source, the provider of the directory platform reduces search costs for users. If a user knew *ex ante* that she would never need to contact several categories of vendors (e.g., dentists, locksmiths, etc.), including these groups would presumably create no added value.

User Structure:

Two distinct structures for network users influence the role of the platform provider. Users may be homogenous (a “one-sided market”) or heterogeneous (hereinafter, “a two-sided network”).³² Homogenous structures are simply those in which users exchange roles frequently – the sender of the fax is often the receiver. Economists offer a more technical definition: “the market for interactions between the two sides is one-sided if the volume ... of transactions realized on the platform depends only on the aggregate price level.” In a homogeneous structure, reallocation of the price between buyers and sellers will not change the volume because buyers and sellers operate in both roles repeatedly.

Two-sided networks, by contrast, have distinct sets of users who consistently play their defined role in a transaction. Eisenmann offers the following example of “credit card networks ... comprised of consumers who hold cards and merchants who accept cards for payment; individual users do not alternate roles.”³³ Such a network allows the platform provider to influence aggregate volume by differential pricing. For example,

³² Although most scholars term this structure a “one-sided market,” Eisenmann makes a valuable point that not all markets are networks and all are two-sided by nature (buyers/sellers) so “homogenous” may clarify the issue.

³³ Eisenmann, p. 13.

yellow page companies give away the directory to users on one side while charging vendors on the other side substantial fees for advertising.

Although this structure appears to leverage a cost advantage for vendors – namely, minimizing customer acquisition expenses – the influence remains on demand on both sides. Customers and vendors must each decide whether to affiliate with the network. Participation from both sides is driven by their demand for the platform’s function. Assuming cross-side positive network effects, “a vendor’s willingness-to-pay for platform participation rights should increase with growth in the customer base on the network’s other side.”³⁴ An essential task of a platform provider is to design a pricing structure that brings both sides into the network.³⁵

Non-pricing features of two-sided networks:

In the presence of network effects, the key objective of a platform provider is to maximize the number of users since the WTP of present and future members increases with network expansion. Although optimizing pricing on each side is a means towards this end, there are other ways that a platform provider may spur demand. As Rochet and Tirole point out, “[providers] often regulate the terms of the transactions between end-users, screen members in non-price related ways and monitor intra-side competition. In all instances, they sacrifice profit by constraining one side to boost attractiveness for and recoup losses on the other side.”³⁶ eBay, a homogenous matching network, encourages user participation through a variety of non-price mechanisms. For example, the company

³⁴ Eisenmann, p. 50.

³⁵ Determining the optimal pricing strategy for each side is complicated and beyond the scope of this paper. For a highly technical review of the matter, see J. Rochet & J. Tirole, *Two-Sided Markets: An Overview* (2004) (working paper available at SSRN.com).

³⁶ Rochet & Tirole, pp. 40-41.

established and rigorously enforces certain standards among sellers, who receive a rating based on their performance. Presumably, eBay could allow anyone to sell, taking a fee from even fraudulent transactions. Over time, however, their membership base would erode and long term value would be destroyed. eBay therefore implements this screening system and other tools that help to distinguish its platform from other online auction sites, drawing more buyers which in turn attracts more sellers.³⁷

Pre-Paid Legal Plans and Matching Networks:

While financial statements may best illustrate the difference between pre-paid legal services and insurance companies, an analysis of the plans as matching networks requires considering the value created by the various services they provide. As **Exhibit A** demonstrates, typical plans primarily offer full coverage for simple, transactional services and then guarantee reduced hourly rates from attorneys for more complicated matters.

Plans Perform a Perform “Directory” Function for Uncertain Transactional Needs:

Direct-to-consumer prepaid legal services appear to have much in common with two-sided matching networks. The primary covered services for most of these plans, including Pre-Paid Legal Services, Caldwell Legal USA and Legal Club of America are legal forms and document review (see Exhibit A). Even simple litigation tends to be offered at merely reduced hourly rates. When users are not certain what forms they’ll need or who they’ll require to review documents, the platform with the most forms and attorneys represents the highest value. In other words, when legal plans are satisfying the

³⁷ eBay website accessed on 21 December 2005.
(<http://pages.ebay.com/aboutebay/thecompany/companyoverview.html>)

needs of users with uncertain and various transaction needs, they look a lot like a two-sided matching network. The provider facilitates the discovery process for both sides (users and attorneys), incrementally reducing search costs as more available options aggregate on one platform. The following pitch on Pre-Paid Legal Services website offers an example:

“Now, with access to over 60,000 legal forms at our [Forms Service Center](#), the document you need may be only a few clicks away. The process is simple and easy. And remember, your membership gives you the power to do what only the wealthy could afford to do until now. You can have your personal legal document of up to 10 pages reviewed by an attorney and receive advice for your protection - BEFORE you sign.”

-Pre-Paid Legal Services Website (www.prepaidlegal.com)

Such marketing of these plans suggest managers are aware of the “directory” function. They expect that users’ WTP for the plan is higher because they offer 60,000 forms rather than 6. Attorneys meanwhile are attracted to a plan like Pre-Paid Legal because it includes 1.5 million members, enhancing customer flow for predictable services that require high volume (e.g., document review).³⁸ Sonia Banerji explained: “For lawyers, prepaid is a volume business that depends on low utilization by plan members of covered services.”³⁹ Since services are relatively standard when limited to simple forms, maximizing the network’s usage depends more on price optimization than quality control. Nevertheless, the providers continue to provide a screening function for customers that catalyzes their demand and thus generates more value for the network’s attorney pool.

³⁸Since the attorney pool in union plans is fixed with full-time salaried attorneys, higher employee usage does not increase value to attorneys because their compensation does not depend on the volume of services performed. Likewise, the incremental attorney only benefits union members to the extent that she offers an additional, desirable service which UAW had not previously provided.

³⁹ Sonia Banerji, *A Survey of The Prepaid Legal Services Industry* Delivery of Legal Services course packet, p. 1005.

Although the presence of uncertain needs may drive the network effect, it is important to further distinguish Pre-Paid's offering from insurance, which manages uncertain needs. As discussed earlier, this is not a cushion against unexpected calamities so much as a means to reduce search costs. Seen in this light, the appropriate economic analysis for a potential member of a legal plan is different than for someone considering insurance benefits. A user does not analyze the expected value of large losses⁴⁰ and her own risk aversion, but rather compares the cost of plan membership against obtaining these goods/services individually.

Plans Leverage Scale Advantages for Certain Transactional Needs:

For certain covered services that all users are likely to require, the benefits of pre-paid legal plans derive less from network effects than cost-reduction. First, the plan eliminates acquisition costs for attorneys. Without a legal plan, lawyers will incur a selling cost in marketing even the most basic service (e.g., will preparation). Legal plans offer a steady stream of clientele that eliminates the need for heavy marketing. Second, users may not fully use the services for which they have paid. Although everyone likely needs a residential lease reviewed or a will prepared, attorneys and plan providers can count on some members ignoring these services, even if covered. Low usage rates of plan members lower costs to attorneys and allow them to deliver prices for a group of services at rates lower than if they contracted for each service individually. In order to drive membership to the plan, therefore, direct-to-consumer providers not only take advantage of the network effects of a matching network but also the scale advantages that allow cost-reduction. Indeed, these two phenomena likely interact with one another. The

⁴⁰ Expected value of loss equals probability of loss times the amount of loss if it should occur.

scale advantages allow a pre-paid plan to offer lower prices; by optimizing prices they fuel the virtuous circle of a two-sided matching network.

Plans Resemble a Matching Network for Even Some Non-Transactional Legal Needs:

When the needs are not transactional and thus by definition more varied, cross-side network effects may still operate. For example, the value to a Pre-Paid Legal user should increase as a great divorce attorney enters the attorney network, even if divorces are not covered by the plan. Providers like Pre-Paid Legal can only offer guaranteed hourly rates inside the network and since scale advantages allow them to obtain lower guaranteed rates from plan attorneys a user's WTP is likely to increase as the pool of qualified attorneys increase since more are available at the guaranteed rate to manage a complicated legal matter.⁴¹ Growing the pool on the customer side increases the value of participation to attorneys, too. As Banerji makes clear, many attorneys affiliate with plans in order to access clients for more complicated legal services: "prepaid is a ... business that depends on ... the eventual need of plan members for a lawyer for non-plan work."⁴² To the extent that customers join Pre-Paid Legal because they expect complicated legal matters and want access to guaranteed hourly rates, their addition generates positive externalities to existing attorneys on the other side. Thus, the provisioning of guaranteed rates for complicated legal matters, while not insurance, may lead to a cross-side network effect.⁴³

Plan providers may optimize this network effect through quality control rather than price optimization. As discussed above, a user's WTP for guaranteed rates will

⁴¹ Hourly rates may still create certain incentive conflicts.

⁴² Banerji, p. 1005.

⁴³ By contrast, intra-side network effects are absent here. Attorneys are unlikely to value a plan more on account of additional attorneys joining its network.

increase when an additional *qualified* attorney joins the platform. If the provider does not exercise a rigorous screening function then a user is less likely to have any confidence that the addition of an attorney to their pool improves their options. Without screening, therefore, the platform provider cannot benefit from the positive externalities of cross-side network effects for complicated legal matters, even if scale advantages allow lower prices.⁴⁴

Conclusion:

Although popularly termed as “legal insurance,” it should be clear that pre-paid legal plans fail to offer the risk mitigation function essential to insurance. Some argue that Americans do not need pre-paid plans to mitigate the cost of catastrophic legal bills because the contingency fee system affords access to such legal services. As W. Kent Davis argues, “[contingent fees] enable individuals to press forward with claims that would otherwise remain unprosecuted for lack of funds.”⁴⁵ Proponents of contingent fees effectively suggest that risk mitigation may be done by lawyers themselves rather than by insurance companies as in Europe.⁴⁶ However, contingent fee lawyers not only eschew certain cases that might incur large legal fees without monetary judgments, e.g., complicated divorces, but they also restrict their intake to the most profitable causes – namely those where the risk of loss is very low or the judgment will possibly be very lucrative. As one scholar has observed, contingent fee lawyers “vigilantly avoid

⁴⁴ For a detailed account of quality control procedures of various plans, see Herbes, pp. 915-921.

⁴⁵ W. Kent Davis, *The International View of Attorney Fees in Civil Suits: Why is the United States the "Odd Man Out" in How it Pays its Lawyers* 16 ARIZ. J. INT'L & COMP. L. 361(1999) as quoted in Lua Kamal Yuille, *No One's Perfect (Not Even Close): Reevaluating Access to Justice in the United States and Western Europe* 42 COLUM. J. TRANSNAT'L L. 863 (2004), p. 894.

⁴⁶ W. Pfennigstorf & A. Schwartz, *LEGAL PROTECTION INSURANCE, AMERICAN AND EUROPEAN APPROACHES*, Chicago: The American Bar Foundation (1986), pp. 7-13.

unpromising cases [and this] ... gatekeeper function provided by ... lawyers prevents the system from providing complete access to justice.”⁴⁷

Therefore, an alternative insurance-like system may be necessary to fill in the many gaps left vacant by contingent fee lawyers. Some scholars have argued for a government-operated reimbursement system resembling the *judicare* model of the U.K., although America’s experience with attempts to provide universal health care suggests some of the challenges such a system would face.⁴⁸ Developing a comprehensive legal insurance plan is beyond the scope of this paper. We seek only to highlight that the structure and benefits of pre-paid legal plans belie their claims to providing legal insurance. Companies like Pre-Paid Legal Services Inc. may offer a valuable “directory” function but they do not mitigate major legal risk.⁴⁹ Other mechanisms will need to fill the void in order to insure citizens have the legal assistance they require.

⁴⁷ Yuille, p. 895.

⁴⁸ See Michael Frakes, *Judicare Reimbursement Structure: Guidance from the Experience of Medicaid / Medicare* Delivery of Legal Services course packet at 949.

⁴⁹ Pre-Paid Legal Services is careful not to use the word insurance on its website. This may be the result of past litigation. It does however describe the company story as beginning in response to the founder’s recognition that while he had auto and health insurance he did not have anything to cover his legal bills.

Exhibit A – Typical Pre-Paid Legal Plans⁵⁰

Legal Club of America – Family Legal Plan (www.legalclub.com)

Legal Club of America offers union members access to a nationwide network of over 22,000 attorneys that have contracted to provide members with Free and discounted legal care. The entire attorney network will provide each member with 7 unlimited, free services including:

- Free Simple Will w/ Free Annual Updates One-on-One consultations for new matters
- Unlimited phone consultations (for each new legal matter)
- Phone calls made and letters written on your behalf
- Assistance in solving your problems with government programs
- Helpful advice on representing yourself in small claims court
- Attorney review of legal documents (6 page max.) per new matter
- AND MORE!

Plan attorneys will also abide by a deeply discounted schedule of commonly used legal services for which they will only charge a one time fee.

Legal Service	Privilege Rate
Traffic Ticket Defense	\$89.00
Bankruptcy Chapter 7	\$250.00
Divorce (Simple)	\$210.00
Non-Support (Spouse/Child)	\$239.00

In addition each attorney further contracts to never charge more than **\$75.00** per hour for all extended legal care that goes beyond the free and discounted schedule.

Membership includes union member, spouse, dependents 23 and younger and any relative living with the member and dependent upon them.

⁵⁰ Pre-Paid Legal Services, Inc. offers a standard family plan that varies by state. It appears that the plan is very similar in structure to these samples, with broader protection in motor vehicle situations due to the company's history of serving victims of car accidents.

Exhibit A – Typical Pre-Paid Legal Plans (cont.)

Pre-Paid Plans – Liberty Legal (www.prepaidplans.com)

- Free Attorney Provided Legal Services:
 - Initial phone consultations during business hours for new legal matters
 - Attorney review of legal documents (6 page max.) per new matter
 - Necessary calls by your attorney per matter
 - Necessary letters by your attorney per matter
 - One-on-One consultations for new legal matters
 - Simple wills for you and your family
 - Helpful advice on representing yourself in small claims court
 - Guaranteed Hourly Rate of \$75
 - Contingency Fee Discounts
- Guaranteed Fixed Hourly Rates:
 - In the event a member requires extended legal representation, our plan member attorneys have contracted with us to **NEVER** charge more than \$75.00 per hour for in or out-of-court representation. In most cases, the attorneys will be able to estimate the amount of hours any given case may consume prior to beginning work on the case.
- Deeply Discounted Fee Schedule of Eight Commonly Used Legal Services
(*Specific definitions apply. Costs and filing fees additional*):
 - Traffic Ticket Defense: \$89.00
 - Chapter 7 Bankruptcy: \$250.00
 - Name Change: \$155.00
 - Simple Will w/ Trust: \$170.00
 - Nonsupport of Spouse/Child: \$239.00
 - Simple Divorce: \$210.00
 - Register Incorporation: \$295.00
 - Personal Real Estate Closing: \$175.00
- Contingency Fee Discounts:
 - Attorneys often work on a contingency fee basis on cases such as personal injury and collections. This fee is usually expressed as a percentage of the amount collected or awarded. In some cases, fee maximums are set by state law. In these matters, member's fees will be a 10% reduction of the state maximum rate or the attorney's usual rate, whichever is lower.

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